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# Financial Markets

Irving Trust

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(Noon)

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We are currently going through one of those interesting periods when both the stock market and the bond market are giving off the same signals. Despite another flurry of merger and acquisition activity (an indication that stocks are too cheap), the stock market can't seem to avert its decline, let alone move higher. Bond prices have (generally) gone back below their worst levels of last year; the long bond's yield of 12.35% seems quite large unless long-run inflationary expectations are two to three times what they are for the near term. So why are these markets so pessimistic? Is the stock market forecasting a recession?

I believe that interpretation of the stock market is misguided. The stock market and the bond market both function more as discounting mechanisms than as forecasting machines. In August of 1982, the stock market began a new set of calculations. As the market soared, analysts saw a brighter future and seemed to be willing to project strong performance fairly far down the road. Now, however, the future of 1982 is at hand: 1984 and 1985 can be analyzed more clearly, and they don't look so good anymore. Yet the present picture is quite positive: The economy is strong; the unemployment rate has fallen faster than the most optimistic would have hoped; and the inflation rate is low. The bad news lies in the future, and this is where the discounting function of markets becomes important.

The prospect of high interest rates is not good for either the stock or the bond market. High real interest rates imply that the return to capital must be even greater to make investment lucrative. Some have tried to explain the persistence of high real rates the other way around, arguing that the change in the tax laws has actually increased the return to capital and enabled business to borrow at even higher interest rates. Thus the tax breaks are blamed for the high rates. I don't agree with this view. High rates are a function of tight monetary policy (which raises the current level of rates) and of fear of the future (which steepens the yield curve). The markets are putting a sizable discount factor on the future.

Market participants know that we are living on borrowed time in the form of too much money borrowed by the government and too much capital imported from abroad. We don't see the effects of this policy now, but that doesn't mean that sinister things aren't afoot. Yet policy rarely reacts to the unseen menace, as history shows. The markets have learned from their experience of low rates of return in the 1970s, particularly on bonds. Thus market skepticism breeds frustration and anxiety, which lower the prices of financial assets and add to the perceptions of policymakers that a problem exists. And so it is that the invisible hand makes the unseen menace apparent to all. I see this as a proper working of economics and of markets. Yet I don't know that these markets are correct. Their discounting is not very formal in a mathematical sense. Participants see the risk of inflation if budget deficits are large and monetary policy is lax. But if deficits are large and monetary policy is tight, high interest rates may cause a recession, and inflation would not be a problem. In the face of this uncertainty, the markets are discounting. It's very hard to say that they are wrong, even though we can't be sure that the markets know what is going to happen.

Robert A. Brusca

# Irving Trust

# Market Yields

| | 3/9/84 (Noon) | Week Ago | Year Ago |
|---|---|---|---|
| **Prime Lending Rate at Irving Trust Company** | 11.00% | 11.00% | 10.50% |
| Effective since | 8/8/83 | | |
| **Discount Rate at Federal Reserve Bank** | 8.50 | 8.50 | 8.50 |
| **Federal Funds** | 9.75 | 9.75 | 8.25 |
| **Repurchase Agreements** | 9.55 | 9.40 | 8.38 |
| **U.S. Treasury Issues** | | | |
| **Bills** | | | |
| 3 months | 9.71 | 9.49 | 8.54 |
| 6 months | 10.13 | 9.89 | 8.72 |
| 1 year | 10.41 | 10.16 | 8.96 |
| **Coupons** | | | |
| 2 years | 11.20 | 10.95 | 9.63 |
| 4 years | 11.76 | 11.47 | 9.95 |
| 7 years | 12.18 | 11.90 | 10.40 |
| 10 years | 12.30 | 11.98 | 10.52 |
| **Long Bond** | 12.40 | 12.08 | 10.66 |
| **Negotiable Certificates of Deposit-Secondary Market** | | | |
| 1 month | 9.80 | 9.60 | 8.55 |
| 3 months | 10.00 | 9.70 | 8.65 |
| 6 months | 10.25 | 9.95 | 8.70 |
| 1 year | 10.75 | 10.60 | 9.15 |
| **Banker's Acceptances** | | | |
| 1 month | 9.88 | 9.66 | 8.55 |
| 3 months | 10.10 | 9.89 | 8.65 |
| 6 months | 10.43 | 10.13 | 8.75 |
| **Eurodollar Deposits** | | | |
| 1 month | 10.19 | 9.94 | 9.13 |
| 2 months | 10.31 | 10.06 | 9.25 |
| 3 months | 10.44 | 10.19 | 9.31 |
| **Commercial Paper - Prime Names** | | | |
| **Directly placed by:** | | | |
| **Finance Companies** | | | |
| 1 week | 9.85 | 9.50 | 8.51 |
| 1 month | 9.86 | 9.61 | 8.68 |
| 3 months | 9.87 | 9.76 | 8.68 |
| **Bank Holding Companies** | | | |
| 1 month | 9.19 | 9.07 | 8.30 |
| **Dealer Placed:** | | | |
| 3 months | 10.13 | 9.80 | 8.66 |
| **New AA Corporate Utility Bond** | 13.55 | 13.00 | 11.90 |
| **Tax Exempt** | | | |
| 6 month Project Notes | 5.35 | 5.25 | 4.40 |
| 1 year AAA Bond | 5.70 | 5.50 | 4.75 |
| 5 year AAA Bond | 7.00 | 7.00 | 6.00 |
| 20 year AAA Bond | 9.40 | 9.30 | 8.50 |

This information represents prevailing market yields.
**It should not be construed as an offering.**
All yields are on the offered side of the market.

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